

# Primeo v HSBC: first instance battle throws up a number of novel legal issues

UPDATE

Peter Hayden (Managing Partner, Cayman Islands)

In a highly-anticipated judgment handed down earlier today, Mr Justice Jones QC held that Bank of Bermuda (Cayman) Limited (**BoB Cayman**) and HSBC Securities Services (Luxembourg) SA (**HSSL**) (together, the **HSBC Defendants**) breached various ongoing duties in their dual capacities as administrator and custodian to Primeo Fund (in Official Liquidation) (Primeo) prior to the arrest of Bernard Madoff and the discovery of the largest known Ponzi scheme in history in December 2008.

Primeo claims losses of more than USD 2 billion against the HSBC Defendants as a result of their alleged failings as professional service providers to the fund. Moreover, many other Madoff feeder funds have brought proceedings against HSBC and others amounting to tens of billions in potential recoveries for innocent victims of the Madoff fraud across the globe.

The judgment arises out of litigation spanning several years, culminating in a four month trial which finished in late-February this year. The Judge's comments are significant for many service providers operating in Cayman and the investment fund industry generally. Similar to his previous judgment in *Weaving* (subsequently over-turned on appeal), Mr Justice Jones QC discusses the professional and legal standards to be applied to fund administrators, custodians, directors, auditors, brokers and investment advisers. Furthermore, the Judge had to decide novel issues in relation to causation, exceptions to limitation bars, and reflective loss, which will be of interest to lawyers and insolvency practitioners.

## Background

Primeo was incorporated in the Cayman Islands in 1993 and, until 2007, invested directly in Bernard L Madoff Investment Securities LLC (**BLMIS**). Thereafter, Primeo continued to invest in BLMIS indirectly, primarily through another Cayman-domiciled investment fund, Herald Fund SPC (in Official Liquidation) (Herald). Members of the HSBC Group acted as administrator and/or custodian to many feeder funds, including Primeo and Herald, which placed assets for investment with BLMIS.

Following the arrest of Bernard Madoff in December 2008 for operating a multi-billion dollar Ponzi scheme, several feeder funds commenced proceedings against HSBC entities for alleged breaches of duty. Having been placed in liquidation, Primeo initiated proceedings against the HSBC Defendants in February 2013.

Primeo alleged that the HSBC Defendants had been grossly negligent in performing their respective functions as administrator and custodian and, by their breaches of duty, had caused Primeo's underlying investors to suffer more than USD 2 billion in losses. Such alleged duties included putting in place the most effective safeguards to protect Primeo's assets, monitoring the suitability of BLMIS to act as sub-custodian and adopting appropriate valuation procedures.

The trial commenced in early November 2016 and oral closing submissions concluded in late February 2017. During the course of the trial, the Grand Court heard evidence from 10 factual witnesses, including former Primeo directors and senior HSBC executives, and 17 expert witnesses ranging from investment management consultants to a former Director of the FBI.

The judgment of Mr Justice Jones QC was handed down today. Important issues are dealt with in the judgment, including the legal tests for limitation, reflective loss and causation.

### **Breaches of Duty by the HSBC Defendants**

The Grand Court accepted the vast majority of Primeo's case against the HSBC Defendants on fundamental points such as duty, breach and strict liability.

In summary, breaches on the part of the HSBC Defendants included:

- (a) adopting grossly negligent NAV calculation procedures;
- (b) failing to give any consideration or make any recommendations to Primeo in relation to safeguards which were readily available and, if implemented, would have been effective to safeguard Primeo's assets; and
- (c) failing to ensure that BLMIS was and/or remained suitable to act as sub-custodian.

In particular, Mr Justice Jones QC held that HSSL was in breach from August 2002 by not recommending: a separate Depository Trust Company (DTC) account and/or utilising the Institutional Delivery System (the **ID System**); and a separate sub-account at Bank of New York, in each case for the benefit of Primeo or the HSBC clients collectively. By requiring BLMIS to establish a second account (or sub-account) at the DTC in the name of BLMIS, but designated for either Primeo or all of the relevant HSBC clients, each trade would have been settled into the separate DTC account, with the result that the DTC would have issued a settlement notification in respect of each trade.

The Judge accepted expert evidence on behalf of Primeo to the effect that a copy of the notification could have been sent directly to the HSBC Defendants through the ID System, and that the HSBC Defendants could have also gained access to holding statements and other information relating to the sub-account at DTC. This would have provided independent verification that the trades had been carried out.

The Judge found that Madoff would have refused to implement these measures, due to the risk of the fraud being uncovered. The Judge held that, when faced with a refusal from Madoff in these circumstances, any reasonably competent custodian would have either resigned or sought to re-negotiate terms with Primeo to limit its functions and liability.

The Judge also found that, following a sub-custodian due diligence review in 2005, HSSL failed to take any steps or make any recommendation to Primeo in relation to implementing the most effective safeguards. By that stage, it was held to be grossly negligent for HSBC to continue to produce a NAV based on single-source information, i.e. information received only from Madoff acting in three capacities as sub-custodian, broker and investment manager.

EY was Primeo's auditor from 1993 to 2008. The Judge found that, from 2005 onwards, EY's unqualified audit opinion was based, to a material extent, upon custody confirmations provided by HSSL. EY relied upon such confirmations to evidence the existence of assets. Although it issued the confirmations, HSSL had no information from any independent source to verify the existence of the assets supposedly held at BLMIS. Faced with concerns expressed by EY and others, the Judge held that a reasonably competent custodian should have given notice to resign and explained its reasons for doing so. Although there was no legal duty to do so, it would have been commercially unrealistic for the HSBC Defendants to resign without providing an explanation to Primeo.

The Grand Court held that, by virtue of entering into a sub-custody agreement with BLMIS in 2002 (consented to by Primeo), HSSL became strictly liable to Primeo for BLMIS' defaults as sub-custodian. Although HSSL attempted to avoid liability pursuant to an exoneration clause, the Grand Court held that the clause does not apply due to the undisputed fact that BLMIS, acting as HSSL's agent, was guilty of a wilful breach of duty.

Importantly, Mr Justice Jones QC also held that the causes of action which accrued against HSSL from 23 February 2007 (when the relevant custody confirmation was issued to EY) and against BoB Cayman in respect of the February 2007 and subsequent NAV calculations are not statute barred.

In his written judgment, Mr Justice Jones QC labelled the evidence of a number of former and current senior HSBC executives as contrived. Certain HSBC executives were found to have been indifferent to

obvious risk, to have held wholly untenable views, to have ignored potentially serious adverse consequences and to have been inattentive to the point of constituting gross negligence.

However, based on technical legal arguments in relation to whether any loss was suffered, whether recklessness is sufficient for deliberate concealment as it applies to limitation, and reflective loss, the HSBC Defendants have escaped liability at first instance.

### **Strict liability and relevant loss**

It is not disputed that BLMIS misappropriated and misused Primeo's money and perpetrated fraud on a massive scale. Primeo argued that it suffered a relevant loss (for which HSSL was strictly liable) on each occasion that it invested cash with BLMIS. Primeo received, in return for the cash, an asset which was not worth an equivalent sum to the money that Primeo had paid but was rather a potentially worthless right in a Ponzi scheme.

Although the Judge accepted that HSSL is strictly liable for the acts of BLMIS as its sub-custodian, he held that Primeo suffered no relevant loss as a result of any wilful default by BLMIS because Primeo realised the full reported value of the assets by switching to an indirect investment through Herald on 1 May 2007. The Judge ruled that the legal effect of that restructuring transaction was to deprive Primeo of its already accrued claim.

The reality of course is that Primeo did not realise its shares in Herald prior to the collapse of the BLMIS Ponzi scheme, and did not therefore succeed in realising the full reported value of the assets as at 1 May 2007 or otherwise. It is not disputed by Primeo that it is required to give credit for the actual value realised for its shares in Herald.

This is a novel legal point.

### **Reflective loss**

The Judge held that Primeo's claim for the loss of its investment (and consequential loss of profit on any other investment) is irrecoverable due to the rule against reflective loss. He found that the loss claimed by Primeo is not separate and distinct from the losses claimed or capable of being claimed by Herald and Alpha<sup>1</sup> in their own proceedings against HSBC entities. The Judge made this finding despite the fact that, *inter alia*, each of the funds was incorporated at different times and the contractual arrangements were governed by different legal regimes. Moreover, Primeo was not a significant shareholder in Herald or Alpha prior to May 2007 and Primeo's causes of action had accrued prior to that date.

Primeo submitted that the correct test is whether any claim of Herald or Alpha is available on the facts, i.e. is a claim that, on the balance of probabilities, is likely to succeed. However, the effect of the Judge's ruling is that a good claim by Primeo would be barred wherever Herald and Alpha have a claim with a real prospect of success (even if their claims ultimately fail).

Furthermore, Primeo argued that the reflective loss principle should not apply to Primeo's claims for loss of profit and loss of a chance, being claims for non-reflective consequential loss.

Similar to the issue regarding relevant loss arising out of the strict liability claim, these are novel legal points and have not been tested at appellate level.

### **Limitation**

As referred to above, the Judge held that the parts of Primeo's claim referable to the period after 20 February 2007 were not barred under the Limitation Law.

However, he rejected arguments made by Primeo that the HSBC Defendants deliberately concealed their wrongdoing so as to extend the limitation period. He did not accept that recklessness is sufficient to amount to a *deliberate commission of a breach of duty*. Therefore, the Judge found that despite his other findings, for example, that senior HSBC executives *did not apply their minds to and failed to consider*

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<sup>1</sup> Primeo began investing in Alpha Prime Fund Limited, another Madoff feeder fund.

*whether any safeguards, or any more effective safeguards, could or should be implemented, causes of action before February 2007 were time-barred.*

The Judge also held that, on the facts of the case, nothing could have been concealed from Primeo, because Primeo already had all the necessary information to bring its claim. In light of the Judge's factual findings on breach and in relation to the general conduct of the HSBC Defendants and senior HSBC employees, it is surprising that the Judge formed this view.

### **Causation**

The Judge held that Primeo had not established that the HSBC Defendants' serious breaches of contract were an effective or dominant cause of Primeo's lost investments. The established test is not that the breach is the sole cause of loss but rather it must be at least one of the elements that caused Primeo to continue to place funds with BLMIS.

Primeo called three former directors of Primeo, two of whom reside in Austria. Primeo also served a number of hearsay notices in relation to transcripts of evidence given by former directors in Austria and Primeo's liquidators obtained thousands of contemporaneous documents from multiple sources, including former directors. However, on the facts of the case, the Judge found that there was *no evidence from any of those who would actually have made the decision to withdraw* Primeo's investment.

As many readers will be aware, liquidators are in a uniquely challenging position in relation to evidence gathering. They often have no power to compel individuals to give evidence and have no entitlement to documents falling outside the realm of their statutory powers (in Cayman, sections 103 and 138 of the Companies Law). Even where there is a clear entitlement, third parties will often fight to restrict access to documents. By way of example, the HSBC Defendants, as key service providers to Primeo, resisted the Primeo liquidators' early attempts to gather information and documentation.

Leaving aside fundamental flaws in the Judge's reasoning on causation, this is a dangerous precedent which, if not over-turned, may make it almost impossible for liquidators to prove the causation element of breach of contract claims. In this litigation, due to the Judge's findings on strict liability, it may not be necessary to succeed on causation on any potential appeal. However, often causation will be an essential element of any claim and this part of the Judge's decision is particularly problematic for liquidators.

### **Comment**

Other Madoff feeder funds, including Herald and Alpha, with ongoing claims against HSBC entities are likely to be encouraged by this decision. Without legal arguments in relation to the 2007 restructure and reflective loss, the HSBC Defendants would have been found liable for Primeo's losses.

Primeo's liquidators will now have to consider whether to appeal the novel legal issues.

## Contacts

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**Peter Hayden**  
Managing Partner, Mourant Ozannes  
Cayman Islands  
+1 345 814 9108  
peter.hayden@mourant.com



**Jonathon Milne**  
Counsel  
Cayman Islands  
+1 345 814 9127  
jonathon.milne@mourant.com



**Rocco Cecere**  
Counsel  
Cayman Islands  
+1 345 814 9218  
rocco.cecere@mourant.com



**Jonathan Moffatt**  
Senior Associate  
Cayman Islands  
+1 345 814 9216  
jonathan.moffatt@mourant.com

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